RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Feb. 10, 1988 **LETTER 984**

ENTER 1988: Bullish: An NFC team won the SuperBowl, which according to the Wall Street voodoo-crystal ball is supposed to be bullish. The "January Barometer" was bullish in that the S&P 500 advanced 4.04% for the month. If you go for gimmicks, you should place these two in your plus column. Bonds are up and interest rates are down. If you study history, that's a more legitimate plus for the stock market. The Utility Average bettered a preceding peak -- that's a plus. Market breadth has been improving, and that's a plus.

Bearish: The overriding negative item is that a Dow Theory bear market is in force. Next, the Dow has been sluggish. The 30 Dow stocks are the most carefully analyzed in the world, and when they lag, that's a definite negative. NYSE margins and credit balances are declining and that is bearish (see later section). The short interest on the NYSE took a huge drop of 23%, which is bearish (the shorts think they've seen the worst and are clearing out). All three D-J Averages are holding BELOW their 200-day moving averages -- bearish. The yield on the Dow is 3.6%, still low by historical standards and not far from the zone which identifies a bull market top.

As stated in the last Letter, the Averages are now fluctuating in what I term "no-man's land." This is the territory above the last primary lows (i.e., 1738.74 on Industrials, 661.00 on Transports) and below the last secondary highs (i.e., 2051.89 and 789.43 -- see page 1 chart). No-man's land tends to be difficult and very often deceptive territory. Because this is a confirmed primary bear market, the odds are that the eventual direction of the market ("the eventual breakout") will be to the downside.

Exchange volume has been simmering down, and this too is characteristic of a bear market. As a bear market progresses, the battered players tend to leave the field. That accounts for the declining volume. The old Wall Street adage which states, "never sell a dull market" does NOT apply in a bear market. When the primary trend is down, dullness often precedes the next important decline.

Interesting developments: My Primary Trend Index (PTI), after a period of basing action, has climbed above its 89-day moving average. How do I interpret this? On a cold reading of the PTI, the market trend is up -- at least for the short to intermediate term. However, as seen on DowPow (chart on page 3) the market has not been making any dramatic upside progress, despite the rising PTI. DowPow is still far below the peaks recorded on October 21, November 2, and January 7. The reason for the poor DowPow showing is that market declines have been powerful (with accompanying big downside breadth figures) while the rallies have been tentative (with unimpressive A-D figures).

I want to delve a little further into the action of the advance-decline ratio. When the A-D ratio is rising it means that the majority of stocks on the NYSE are moving up. The reverse is true when the A-D ratio is declining. The A-D ratio topped out on March 25, 1987. It continued to decline to a low of -13.71 on December 4 (see page 2 chart). The December 4 A-D low was not confirmed by a new low in the Dow. At the December 4 low, the market was in an extremely oversold condition.

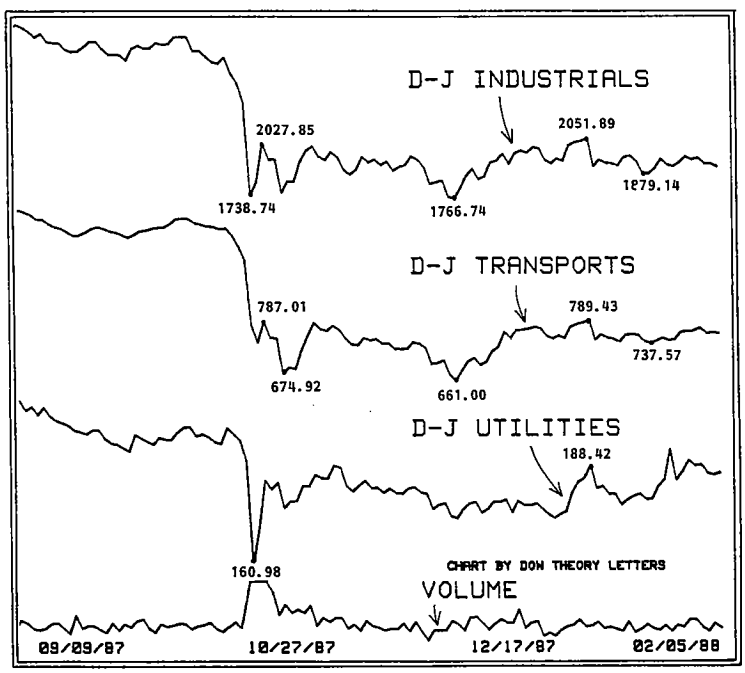
Jan. 29 DJIA 1958.22; PTI 2658; A-D Ratio -10.21
Feb. 5 DJIA 1910.48; PTI 2647; A-D Ratio -10.20
Current Dow Yield: 3.63%: Dow P/E: 13.8
Dow 200-day mov aver: 2259; DowPow: 805

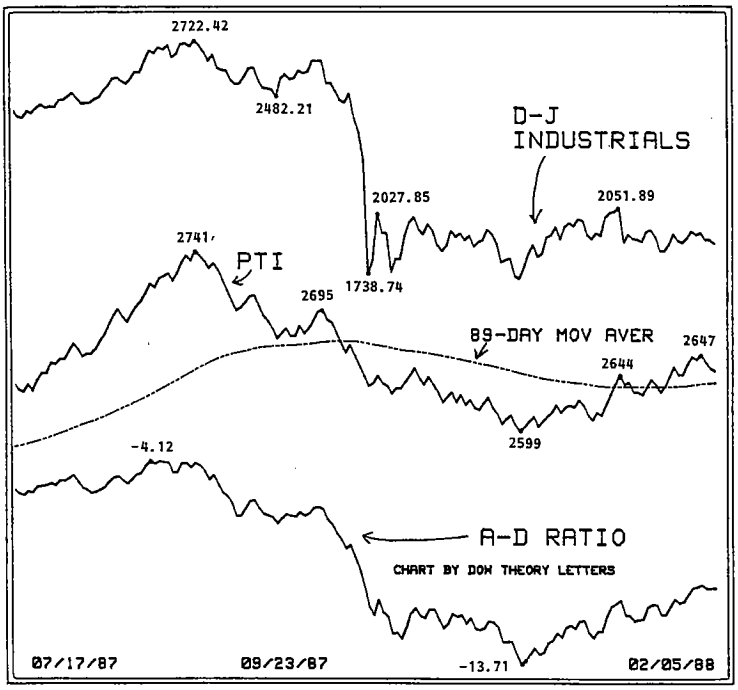
From the December 4 low the A-D ratio turned up. The rise in the A-D ratio has been quite persistent. Most recently the A-D ratio advanced above its October 21 peak to a post-crash high. But now it is the Dow which is lagging. Note on the page 2 chart that the Dow is currently BELOW both its October 21 peak of 2027.85 and its January 7 peak of 2051.89. Thus, we have an important non-confirmation in that the Dow has not confirmed the action of the A-D ratio.

Wall Street folk lore has it that when the A-D outperforms the Dow it is bullish. My studies show, however, that upside breakouts in the A-D unconfirmed by the Dow can bring on trouble. It will now require a Dow closing above the January 7 high of 2051.89 to confirm the superior action of the A-D ratio. If the Dow can't accomplish that -- I look for trouble.

THE PICTURE: "Hope springs eternal ... ." And that's the way it should be. Speaking of hope, it's been nearly four months since the October 15 primary bear signal (plus the worst crash in stock market history), and many experts, gurus, and soothsayers are already proclaiming "a new bull market." Maybe so, maybe the 1987 bear is just a corpse here in 1988, but one thing that history has taught me is that bear markets tend to last around one-quarter to a third as long as the preceding bull market.

Furthermore, the length and extent of a bear market tends to have a direct relationship to the length and extent of the preceding bull market. So as I see it, if the bear market which began in mid-August 1987 ended on October 19, 1987 (the day of the crash low), then we have just witnessed the shortest bear market in recorded history.





But as I've warned many times, the bear can be a fooler. He can be a living devil. He's out to separate you and me from our assets -- that's what he wants to do, that's what he lives for. Now the following is not a prediction; it's just an observation. So please turn to the chart on page 2 (courtesy of A. Gary Shilling & Co. Inc.). What you see here is a ratio chart showing the Dow (monthly ranges) during the period of 1922 to 1931 and comparing that picture with the Dow during the period of 1980 to 1987.

The important item to note here is that following the 1929 crash the market corrected sharply and persistently to the upside. By April of 1930 the bear had people thinking they were back in seventh heaven and that the crash was just a nasty mistake. By April 1930, the Dow had recovered better than 52% of its 1929 crash losses. But the stock market turned down in May, and the next two years made the 1929 crash look like a tea party.

Now as I said, there's no particular reason why the aftermath of the recent 1987 crash has to resemble the aftermath of the 1929 crash. But there are a number of reasons why I believe that the action of August to October 1987 did not end the bear market. Frankly, I fervently "hope" the drop from the Dow's August high of 2722.42 to the October low of 1738.74 was the whole bear market. But my studies, my experience, and my intuition all tell me that it's just not going to be that easy. Let me put it another way -- I wouldn't want to be the president that takes over from Ronald Reagan.

All right, it's obvious that the page 2 chart presents the absolute worst and scariest possibility for the current bear market. What is the best case? Interestingly, there is another (happier) scenario which could materialize, and that scenario is best illustrated by the market action that followed the crash of 1946.

Let me describe that situation briefly. On May 29, 1946 a great bull market topped out at Dow 212.50. From there the market turned down. In August the market crashed, and by October 9 the Dow was down to 163.12, a loss of 23% (although many secondary stocks did much worse). By June '48 the Dow had recovered to 193.16. A new decline then took the Dow down. to the famous June 13, 1949 low of 161.60. Note that three years had passed since the '46 crash low, but the 1949 low of 161.60 was only 2 points below the 1946 crash low of 163.12. In other words, almost all the damage occurred during the crash and the first five months of the 1946-49 bear market.

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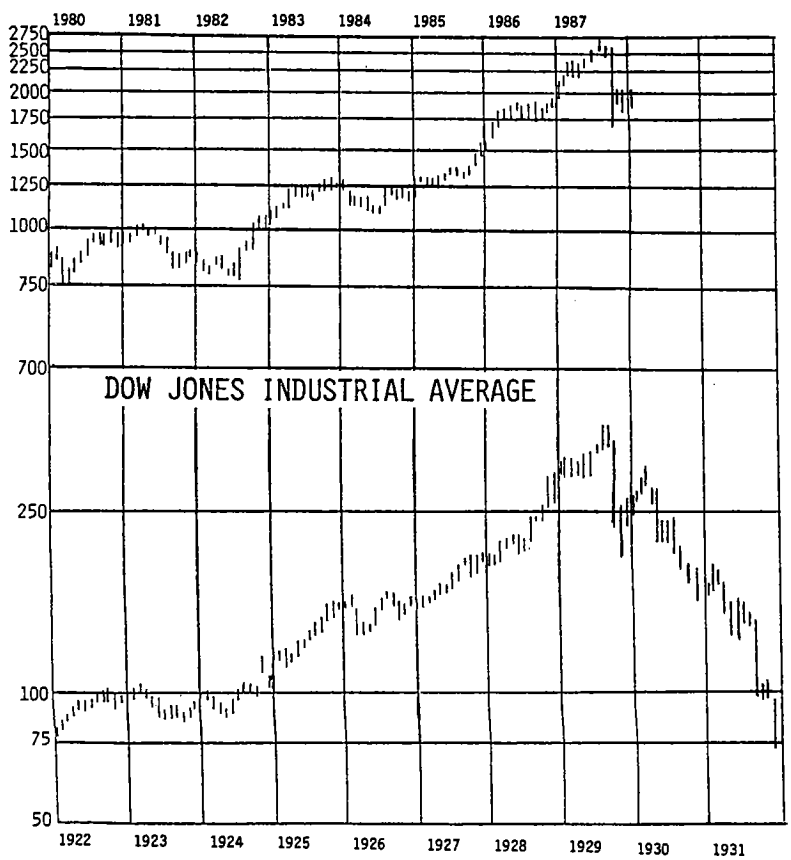
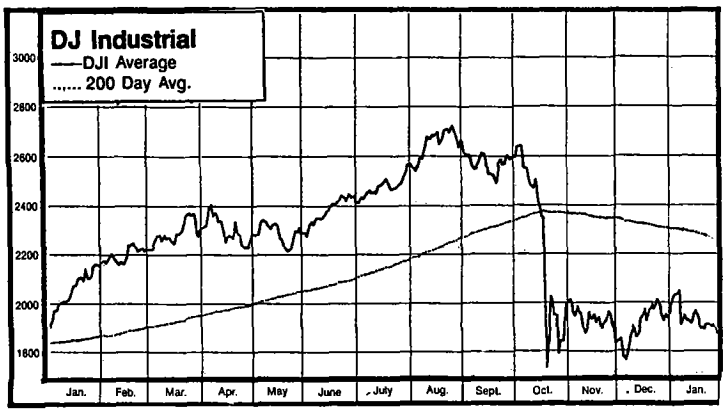
Suppose the 1946-49 post-crash experience were to be repeated here in 1987-88, what might we expect? If the 1946-49 experience was to be repeated, we might expect a trading range type of market with the Dow fluctuating between the crash low of 1738 and a high of 2200 or thereabouts. But if the 1946-49 post-crash experience is fated to be repeated, **IT'S GOING TO TAKE TIME.** In other words, the bear market that began in August 1987 could stretch out to 1989 or 1990 with the Dow moving up and down in a series of extended, exasperating, deceptive moves.

Mind you, I'm not saying that we are fated to see 1946-49 repeated, I'm saying that such action is a possibility. How will we know? When will we know? In answer to this question I suggest that readers review the 50% Principle article in the last mailing. Let's say a year or two go by and during that period all the indications of a bear market bottom appear, and further that the Dow has still not smashed decisively below the 1650 level, this will be a very hopeful sign. It will be a sign that the bear market can and will be contained.

On the other hand, if during the period ahead the Dow breaks decisively below 1650 you can forget about 1946-49. In that case, I would say that we are in for a crushing bear market of the most severe kind.



At this point the study of the Dow in relation to its 200-day moving average is of more than passing interest. One way of judging an oversold market is to watch the distance between the Dow and its 200-day MA. At the October 19 crash low the Dow was an astounding 26% below its 200-day MA. To say that the Dow was oversold on October 19 was a major understatement. The question everyone asked after the crash was -- when can we expect the next major (corrective) rally.



In a normal market, when the Dow is drastically oversold, we can expect a strong rally, a rally which will approach or even touch the 200-day MA. But if market conditions are weak, we will occasionally see a situation where the Dow moves sideways while the MA declines and finally even touches the sluggish Dow. Thus, instead of relieving the oversold condition with a rally, the oversold condition is relieved through time as the 200-day MA descends to meet the sideways-moving Dow.

This could be what has been occurring since the crash low. The rally from the October 19 low has hardly been inspiring, but note on the chart that the 200-day MA has been declining and in time it will meet the sideways-moving Dow. The MA is now declining at the rate of roughly 1.9 points a day. (Please turn to Late Notes, page 6, for final comments on the market.)

INVESTMENT POSITION: Is our government engaging in subliminal suggestion or is the US Post Office trying to tell us something? At any rate, Mark Skousen just sent me the PO's new bear stamps, and I'm featuring one of them here. The one pictured here is the Alaskan Brown Bear stamp. In the next Letter I'll include the PO's other bear stamp which they simply call Black Bear.

Nobody watches the Dow dividends more closely than *Investment Quality Trends* here in La Jolla. IQT states that in 1987 Dow dividends increased 6.2% to 71.20. Assuming the Dow advanced to a 3% dividend yield (at which point it would be overvalued again), the Dow would have to rise to 2373. On the other hand, if the bear market took the Dow down to a 6% yield (at which point it would represent great value), the Dow would have to sink to 1187. At its current dividend yield of 3.7%, the Dow is pressing near the overvalued zone. My guess is that before this bear market is over, we will see the Dow again enter the undervalued area.

Position: Out of stocks, still collecting gold coins, still holding high-grade bonds -- extra cash in a money-market fund or in T-bills.

BONDS: I guess I'm not giving away any secrets when I state that I have liked bonds ever since mid-1987. Furthermore, I've been saying (1) that my surest prediction for the rest of the 1980s and beyond is that the American standard of living is heading down and (2) consequently, the operative word for the next five years is going to be INCOME. Why income? The answer is income is what you need to keep your standard of living intact.

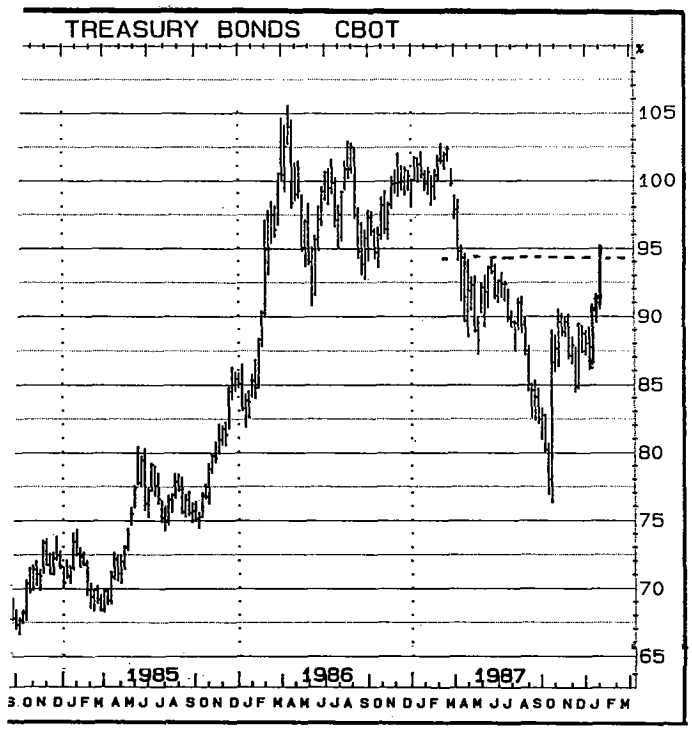
How do you get income? You can marry it. You can earn it. You can obtain it from investments. You can borrow it. Over the last decade Americans have turned increasingly to borrowing to obtain income. There are only two drawbacks to borrowing: (1) borrowed money tends to compound, and I mean compound against you, and (2) borrowed money has to be paid back.

At the peak of the bull market in 1987 the Dow was yielding 2.52% and the D-J 20 Bonds were yielding over 10% for a record-breaking ratio of 4:1 in favor of bond income over stock income. Why -- how did we get this stupefying ratio? The answer is that investors believed that the sky was the limit ("Dow 3600") as far as stocks were concerned, and fears of rising inflation kept bond yields abnormally high.

On both counts investors were WRONG. In fact, they were so abysmally wrong that the markets corrected their wrong thinking by way of the greatest stock market crash in the history of Wall Street -- plus an explosive advance in bonds.

The crash and the subsequent rise in bond prices helped to correct the stock/bond yield ratio. At the latest reading, the yield on the Dow was 3.53% (still low) and the yield on the D-J 20 bonds was 9.63%. This provides a stock/bond yield ratio of 2.73:1 in favor of bond yields over stock yields. That's a lot saner than the absurd 4:1 ratio of August 1987, but it's still high.

Furthermore, I believe that Americans still tend to think in terms of "the coming inflation," and I say this because bonds are still showing high yields in the face of my own deflationary expectations. From what I see at this time, inflation is a "dead duck."



Why do I think inflation is last year's worry? (1) Because we're in a bear market, and bear markets tend to be deflationary. (2) Because the ultimate inflation hedge, gold (and gold shares) and the precious metals, have broken down badly. (3) Because the world is facing a GLUT of almost everything from TV sets to oil, from cars to computers. Furthermore, the undeveloped nations are now entering the manufacturing markets from every side. (4) Because the great majority of Americans NEED and would BENEFIT from inflation, and this includes stockholders, farm land owners, receivers of indexed pensions, corporations and individuals who are in debt or who have issued debt, homeowners, banks which are heavily in debt, and individuals who own junk bonds or who have participated in leveraged buy-outs. With such a huge segment of the population POSITIONED FOR INFLATION, the market is most

apt to deny them what they need. Ironically, that's the way markets work. They're out to frustrate the majority.

The accompanying chart may say it all. Here we see the Treasury bonds slumping from their high in the 102-105 area, then crashing down to 76 in mid-October. From there the bonds reversed violently -- then surged higher. As you can see on this weekly chart, the bonds formed a huge head-and-shoulders bottom with the major resistance first at the 90 level (which they have pushed through) and then at the 94 level (which they punched through last week).

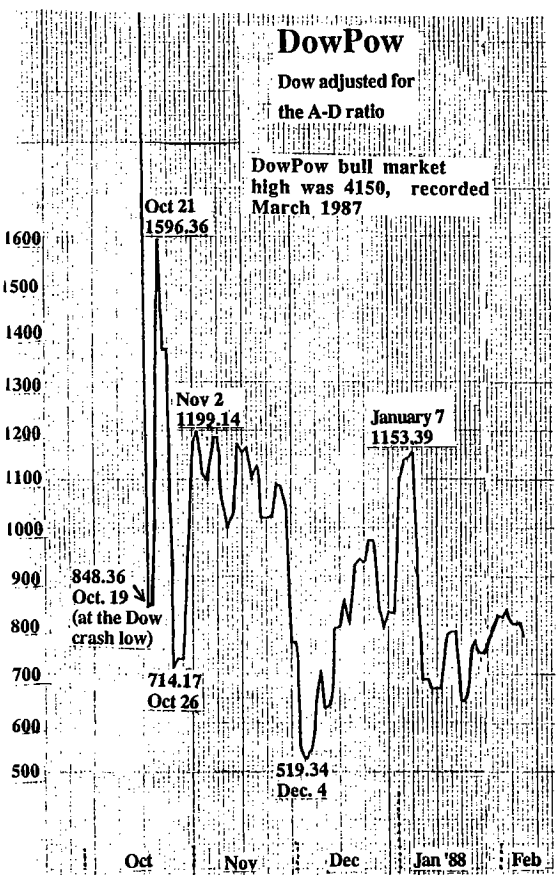
I have liked the bonds (and obviously I liked the fat bond income) and have recommended high-grade bonds for the last few years. For those in high-tax states I have recommended high-grade muni bonds. I continue to like the high-grade bonds, and believe they will outperform stocks over the foreseeable future.

As I see it, the only thing that would justify the current high prices of stocks compared with bonds is if corporate earnings exploded or if inflation took off on the upside. I don't see either of these happening any time soon.

DOWPOW and PTI: Here's an updated daily chart of DowPow, my proprietary index of the Dow adjusted for the action of the daily advances and declines. I've been puzzling over this chart and trying to relate it to the action of my PTI.

The PTI hit a bull market high (page 2 chart) of 2741 on August 24, 1987. That was the top. The PTI then dropped to a bear market low of 2599 on December 4. Since then the PTI has rallied to a February 2 high of 2660. That's a 43% correction of the PTI's bear market losses.

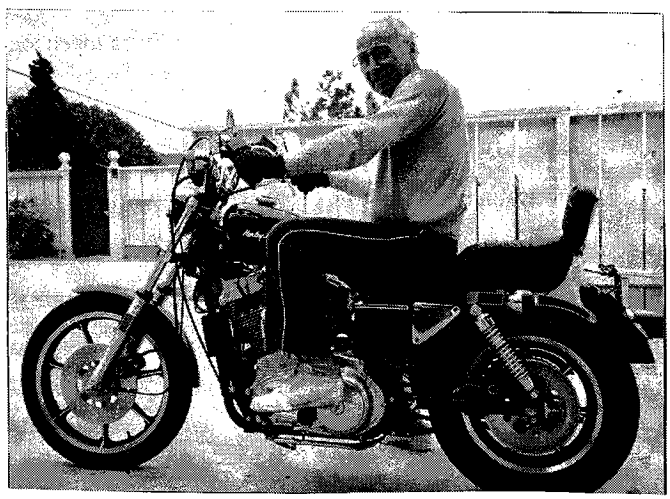
But strangely, DowPow has been very sluggish despite the rise since December 4 in the PTI. I've been trying to understand what all this means. My best conclusion is that the PTI is saying, "the near-term trend of the market is up," while DowPow is saying, "the trend may be up and the market may be working off an extreme oversold condition, but the rise is weak and most stocks are not making much upside progress."



The reason DowPow has been sluggish is that on days when the Dow has been up sharply, breadth has tended to be weak. And on days when breadth has been decent, the Dow has not tacked on many points. But on many downside days, both the Dow and the breadth have both been weak. And DowPow tacks on yardage when both the Dow and the breadth are strong or weak on the same day.

TWO AMERICAN PRODUCTS that are still going strong (me and Harley-Davidson). Ever since my bypass operation back in 1986 subscribers have been writing to ask "Russell, are you OK?" One kindly lady subscriber even sent me a case of low-salt, low-fat chicken soup. As to my health, I've never felt better. After all, would I be riding cycles if I were "down-and-out in La Jolla?"

Anyway, this is a picture my good wife, Faye, took of me a few weeks ago. The bike is an '87 Harley-Davidson 1100 cc Sportster. Nothing spectacular, fancy or high-tech about this machine, but it's the best handling and the most fun to ride of any bike I've ever owned (and I've owned a slew of them -- and yes, I always wear a helmet). Last year Harley couldn't deliver on all its orders -- Harleys are a hot American item, and they are even considered prestige items in Japan. Yes, people will still buy American -- if we'll only manufacture something worth buying.



NOTES & QUOTES: About every six months I find it necessary to write a paragraph as follows: I sincerely appreciate getting letters from subscribers. I read every letter carefully and with interest. Many of the letters are personal and fascinating. Others ask for dates, statistics, charts, detailed information, opinions on individual portfolios, etc. I have 6,000 subscribers, and I'm guessing that ten times that number read these reports. One result is that every day five to a dozen letters from readers arrive here. And I thank readers for them.

But here's my problem. It's impossible for me to do my own reading and research and work on the reports and on top of that answer the letters that come here. Honestly, I do appreciate receiving the letters. Many of the letters contain valuable information which I can and do use in my reports. But I have had to give up answering all the letters that come in daily -- I just don't have the time or the energy. Therefore I just concentrate on doing the best job I can for ALL my subscribers -- and that entails spending my time and energy on Dow Theory Letters.

* *

The US is now as near-rudderless as it can get. Congress does less than nothing about the budget deficits and the President's authority has sunk to a state of near impotency. Reagan ("I'll sign anything") has so far vetoed only 61 bills (as against over 200 vetoes for Eisenhower over the same period). A new study shows that Reagan won only 43.5% of the roll-call votes in Congress that he took a clear position on in 1987. That is the lowest success ratio since 1953 when the Congressional Quarterly began monitoring these votes. Reagan has gone from "lame duck" to "dead duck" status.

* *

Russia is finally planning to join the world -- economically speaking. Russia announced last week that by the late 1990s it will make the ruble convertible into Western currencies. If Russia really wants to make an impression, she'll make it a gold-backed ruble. Russia has the gold to do it.

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Bankrupt former governor John Connally is now urging Texans (on TV and in newspaper ads) to save money via a Houston S&L. Only problem is that the S&L industry in Texas is in disarray and it is estimated that it will require at least $6 billion of federal funds to bail the industry out.

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CASH CRUNCH: Allegheny International, hit by losses and scandal over benefits for former executives, said it needs another $75 million to operate through April.

Speaking of trouble, this little squib from the Feb. 4 *USA Today* may be a harbinger of things to come. If this nation goes into a big bear market recession, the mass of overhanging debt is going to become almost unsupportable. In that case, even though a recession is in progress, interest rates could go up in one final spike. Why? The answer is that we could see a panic to borrow, borrow in order to stay alive. That's what Allegheny is doing now. Multiply this by a few thousand and you'd have the "big interest rate spike that nobody expects."

* *

If you have even the vaguest interest in astrology, February-March should be for you. My friend, Arch Crawford of *Crawford Perspectives* (205 E. 78 St., NYC 10021) is a serious market/astrology student.

In his latest report Arch states that a few "once or twice in a lifetime events" are arriving. Arch says that "all hell breaks loose as Mars joins Uranus on Feb. 22 and then Saturn on the 23. Mars also joins Uranus on North-South orientation (parallel) on the 23 meaning that the conjunction is the most powerful in years and years." Arch says that with all these items coming together, we should "prepare for the worst." He expects big trouble, then a market bottom either on Feb. 23 or Mar. 3-4 -- then a retest of those lows around Mar. 18. "That's it for now, take cover," warns Mr. Crawford. Says Russell: I've seen Arch very right about market turns in the past -- so let's see what happens between now and the end of March.

* *

Last year the after-tax income of Americans grew a sluggish 1.8%. What happened was in order to keep up their standard of living Americans cut their savings rate. They cut their savings during 1987 to 3.8%, the lowest level in 40 years. Then they got scared, probably due to the crash. October's savings rate popped to 5.5%, November's rate was 4.5%,and December's rate was 4.7%. In the meantime, most of the 1987 tax cuts were wiped out by boosts in the ever-rising Social Security taxes (oh, excuse me, they're not really taxes).

* *

One of the problems facing the US economy is consumer debt. Consumers now owe $200 billion more than they did last year. And this is bringing about consumer price-resistance. You can see this in the sales and discounts now being offered by the stores (the big stores profit per dollar of sales fell from 2% last year to 1.8% this year). Although foreign merchandise (most dramatically car prices) have been pushing up to counter the effects of the weak dollar, many domestic prices have been stable to down. Increasing caution on the part of consumers is forcing many manufacturers to proceed with caution and to be very conservative about expansion plans.

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My friend, Arthur Gray, Jr., President of Dreyfus Personal Management, Inc., makes a few incisive observations about 1988 and beyond. (Arthur is a true optimist and a very intelligent one.) He states: Noting that the money supply figures have been going down, down, down, Gray says: "The one thing I know is that all seven Directors of the Fed have been appointed by Ronald Reagan and that a recession now would shoot the deficit up to 300 to 400 billion and the Directors will use all the tools at their command to avoid that." (Russell note: Good thought, Arthur, but can we hold a recession off forever -- or just until the next Presidential election?)

Gray also wisely notes that "the new tax rate is in place. We now have the lowest individual and corporate tax rates in over 50 years. Most taxpayers, naturally, deferred whatever income they could from 1987 to 1988. Since so many skeptics believe that the tax rate will be increased again in 1989 (I don't), 1988 will be a vintage year to record profits and distribute dividend ... ." Gray believes this will result in no recession in '88, increased GNP growth in '88, a lower federal deficit, a stabilized dollar, and lower interest rates. Russell comment: I sure hope Arthur is right.

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I don't know about all the Brady committee reforms, but the more I think about it the more I really wish that the various exchanges had never started with puts, calls, and options, and then allowed program trading, portfolio insurance, and on and on. These latter-day inventions have little or nothing to do with investing and they have nothing to do with raising capital for America. But it's as if one thing has led to another and now we see that all these vehicles add up to four times the volume produced by the buying or selling of stocks themselves. It's the evolution of the exchanges into casinos. It may mean more money for Wall Street, but it also may result in scaring the public out of the market. Remember the old Wall Street adage which states, "stocks are created to be sold to the public." What happens if there's no public?

* *

Big Green: I met Michael Eisner when he was second in command at MGM a few years ago. At that time Eisner was very interested in gold. Since then Eisner has become CEO of Disney, and he has struck gold. Last year Eisner received $6.7 million from Disney, most of it in bonuses (Eisner receives 2% of the amount by which net income for the year exceeds a 9% return on shareholders equity). On top of that Eisner has options to buy 1.2 million Disney shares at $14.36 each and he gets options for another 2 million shares when his contract expires in 1990. Eisner is brilliant and has been fantastically successful at Disney -- and boy, is he getting paid for it!

* *

Art Merrill, who publishes *Technical Trends* (PO Box 792, Wilton, CT 06897) is one of the top technicians and statisticians in this business. In his January 23 report he writes: "I'm seeing a lot of commentary on the decennial cycle lately. Here's the bottom line: only the fifth year of the decade is consistent enough to be statistically significant (11 up and 0 down). While the 8th and 9th year have the next best numbers, 8-2 is not statistically far from random."

* *

The December federal deficit was $23.9 billion. For first quarter 1988 the deficit was $80.3 billion, up $15.80 billion or 25%. Last year federal coffers were sweetened by a windfall one-time tax collection stemming from the 1986 Tax Reform bill. Best bet for 1988 -- a whopping $160-180 billion deficit. Conclusion: The US debt situation continues literally out of control. Comparison: In 1929 the total US debt was $16 billion. The US continues to be eaten alive by deficits -- deficits that are steadily compounding.

* *

The last two heads of China's State Family Planning Commission have been fired. Reason: In 1987 China's population increased by 15 million to 1.07 billion. China's rulers want the population to level off to 1.2 billion and then DROP to 700 million by 2050. The one-child-one-family rule just doesn't seem to be working.

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Recently in the *Kansas City Times* a columnist, Robert Fulgham, wrote a piece in which he claimed that most of what he needed to know in life he learned in nursery school. Here's what he learned (and it seems to me this is more than most people ever learn!): "Share everything. Play fair. Don't hit people. Put things back where you found them. Clean up your own mess. Say you're sorry when you hurt somebody. Wash your hands before you eat. Flush. Live a balanced life. Learn some and think some and draw and paint and sing and dance and play and work every day some."

* *

Even free-trade boosters are getting frightened. Foreigners (read Japan) are eating up America like hungry diners at a gourmet restaurant. Foreigners now control $1.5 trillion in American

resources including over 16% of total US bank asssets, over $100 billion in US real estate, and over 10% of the total US $2 trillion federal debt. Many observers are now worrying that foreign companies and governments are exerting political influence over US policy. It's a corollary of the Golden Rule -- "Who owns the gold (read assets) makes the rules." Said Felix Rohatyn recently, "No major industrial power in the world, certainly not Japan, not even Britain, allows foreign control of major strategic companies to be acquired without government approval." But the cheap dollar and the huge trade deficits make the US an almost irresistible bazaar for foreigners who are piling up dollars. Maybe that's a reason for the weakness in gold. After all, who needs gold when you can buy US assets for 50 cents on the dollar?

GOLD, DOLLAR, FACTS. "Hey, the dollar has turned strong, it's reversed its downtrend." That's what you hear, and what you hear is WRONG. Study the accompanying chart. Note that the Dollar Index has been declining steadily within its bearish channel. Then in December a panic hit, and the Dollar Index plunged well below its lower channel line. This created a classic oversold situation, after which the dollar rallied sharply, aided by last month's slightly better trade figure.

But note -- the Dollar Index did not reverse to the upside. It did not break out of its channel on the upside. In fact, the Index is still sitting on the low side of its declining channel. So nothing of great note has happened so far except that the dollar got heavily oversold, it rallied, and is now moving sideways. The dollar, in brief, has bottomed out temporarily. If and when the dollar breaks out of the channel to the upside -- then I'll be impressed (so, I might venture to say, will this nation's creditors).

The leading economic indicators have declined three months in a row. Housing starts have plunged. Retail sales and auto sales are slow. Inventories are building. So why hasn't the Fed lowered the discount rate? Why has the Fed kept the money supply low? You're looking at the reason -- it's the still shaky position of the dollar.

I offer the following comment. If the dollar was strong, it the US trade position was strong, the Fed would now be actively lowering the discount rate and pumping money into the economy. Right now I don't think the Fed dares. If the US sinks into very slow growth or recession, it will be most interesting to see what the Fed will do.

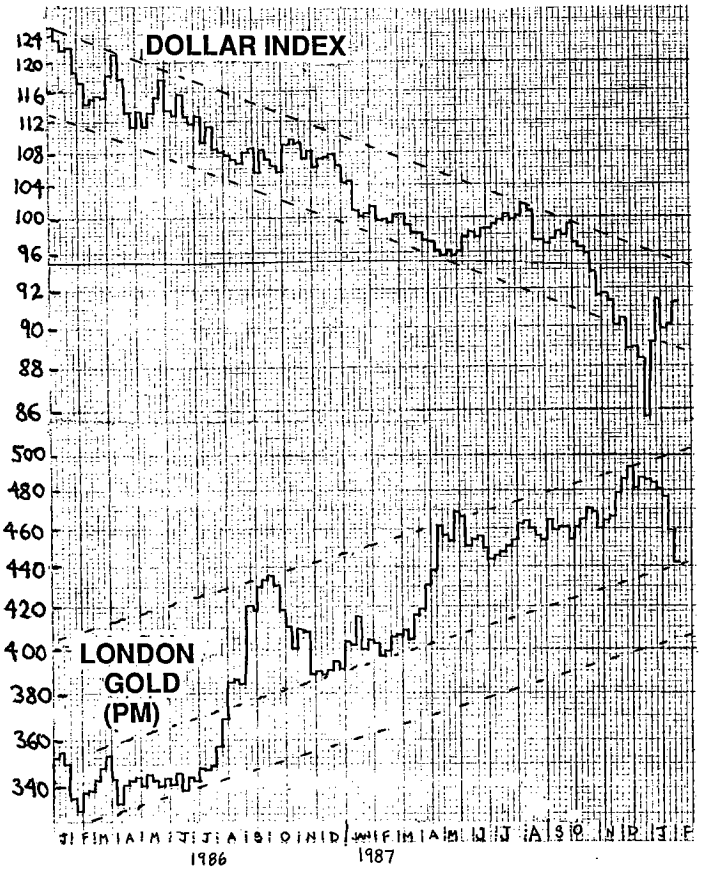
The fact is, you see, the US is no longer master of its fate. When you owe billions of dollars to foreign creditors, you are no longer master of your fate -- your creditors become the masters of your fate. A sad commentary on a great nation, but that's life in the debt-logged US today.

Here's something else. If, for whatever reason, the dollar plunges again in the period ahead, you're liable to see an upside spike in interest rates as foreigners dump bonds. And that, I might add, is the last thing on this green earth that the US Treasury and Fed want to see.

As I see it, the situation today is deflationary. The metals are all down, copper (the last to go) has topped out. Consumer prices are rising slightly, but with today's weak dollar they really should be surging higher (and they're not). The big banks have just had their credit ratings reduced. Bond and stock portfolios are being up-graded. The only thing that's inflationary is people's memories. And of course, most people are still fighting the last (inflationary) war.

What about gold? I show gold still fluctuating within a channel, and so far it's still a rising channel. But there has been weakness within the channel. There was important support for gold at 440. On February 3 the 440 level was broken -- but only slightly. Below 440 the next important support comes in at 400. Personally, I believe that even on further weakness 400 will hold.

The last few years saw a tremendous amount of speculation in



gold, but the frenzy was centered in the gold shares. This year the gold shares have been hit hard, and as subscribers know I was never excited about the gold shares (I didn't like the fact that the N. Americans were very thin on income while the S. Africans had political problems).

As you know, I have NOT attempted to time the gold price action. I have advocated averaging into a gold coin position and using gold as an **insurance policy.** Gold provides no income --therefore it is not and never has been "an investment." What am I personally doing about gold? I continue to buy a fixed dollar amount of gold coins at the first of each month. I'm not buying them out of inflation fears. I'm buying them because I want the metal in my lock-box.

LATE NOTES: Do you remember the January 7 breakout which saw the Dow at 2051.89 and the Transports at 789.43? Well, the Dow is now 150 points lower while the Transports are 35 points lower. If there's to be near-term trouble, keep your eyes on the mid-January lows of 1879.14 for the Dow, 737.57 for Transports (see page 1 chart). If both Averages violate those levels, I would think that the bear was finally emerging after three months of hibernation.

Now refer to Letter 983, page 3, regarding the **50% Principle.** I listed three 50% levels for the Dow, 1650, 1749 and the highest of the three, the halfway level of the entire 1984-87 advance, which was 1904. On February 8 the market opened lower with the Dow breaking below 1900. I consider it a very bearish indication if the Dow cannot hold above even the highest of the three 50% levels. Remember, four months have elapsed since the crash and the Dow is still struggling at the halfway level of the 1984-87 rise -- an ominous performance so far.

Meanwhile, with the bonds strong and gold weak, the bond/gold ratio is hinting at dis-inflation (deflation if you want to be really mean). If deflation is the wave of the future, the US deficits will loom as increasingly difficult to handle (the worst economic scenario I can conjure is one of rising debts within a deflationary environment).

NEXT MAILING: Feb. 24